

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
ESTATE OF ALICE M. FASHANA	:	DETERMINATION
D/B/A ANGELO'S CORNUCOPIA	:	
for Revision of a Determination or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period September 1, 1984	:	
through May 31, 1987.	:	

Petitioner, Estate of Alice M. Fashana d/b/a Angelo's Cornucopia, 412 North Main Street, North Syracuse, New York 13212, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1984 through May 31, 1987 (File No. 805356).

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 333 East Washington Street, Syracuse, New York, on October 18, 1988 at 9:15 A.M., with all briefs to be filed by December 16, 1988. Petitioner appeared by Edward R. DeLaura, C.P.A. The Audit Division appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

ISSUES

I. Whether, in estimating petitioner's sales tax liability, the Division of Taxation used a method reasonably calculated to reflect taxes due.

II. Whether petitioner has shown that its failure to comply with the Tax Law was due to reasonable cause and was not due to willful neglect.

FINDINGS OF FACT

1. On December 18, 1987, the Division of Taxation (the "Division") issued to petitioner, Estate of Alice M. Fashana d/b/a Angelo's Cornucopia, a Notice of Determination and Demand for Payment of Sales and Use Taxes Due, for the period September 1, 1984 through May 31, 1987, assessing tax due of \$50,647.13, plus penalty and interest.

2. Angelo's Cornucopia was a full-service Italian restaurant. A review by the Division of petitioner's 1984 Federal income tax return disclosed a substantial difference between sales reported on petitioner's sales tax returns for that year and gross receipts reported on its Federal schedule C. As a result, an audit of petitioner's business was commenced.

3. The auditor sent a letter to Angelo's Cornucopia scheduling a field audit appointment. The letter requested that the following documents be made available on the appointment date: all books and records pertaining to petitioner's sales and use tax liability for the audit period,

including journals, ledgers, sales invoices, purchase invoices, cash register tapes, Federal income tax returns and exemption certificates. The auditor was referred to petitioner's accountant, Edward R. DeLaura, for any information which would be needed to complete the audit.

4. During the course of the audit, the auditor made a request to Mr. DeLaura for all records of Angelo's Cornucopia then in his possession, including specifically, records of all purchase expenditures, e.g., a purchases journal. The only records made available by Mr. DeLaura were monthly bank statements, cancelled checks, payroll records, and 1983 and 1984 Federal returns. Worksheets used in preparing the income tax returns were requested but not provided. Petitioner did not file Federal income tax returns for the years 1985, 1986 and 1987.

5. Mr. DeLaura calculated petitioner's gross receipts for the 1983 Federal returns by adding sales, as shown on the sales tax returns, to the business's payroll costs. He did so because he considered reported taxable sales to be understated. He stated at hearing that he could not recall how gross receipts were determined for other years.

6. The auditor compared reported sales as shown on sales tax returns filed for the period December 1, 1983 through November 30, 1984 to gross receipts as found on the 1984 schedule C and found that gross receipts exceeded taxable sales by approximately \$49,156.00. The auditor also examined petitioner's bank statements for the period September 1, 1984 through February 28, 1987 and found total deposits of \$404,361.41. Sales reported on sales tax returns filed for the same period were approximately \$121,440.00.

7. Because petitioner's records indicated that sales were inaccurately reported and no sales records were made available to verify reported taxable sales, the auditor used a formula based on payroll records to estimate sales tax due.

8. During the audit period, petitioner's payroll records were prepared by an independent company called Paychex. As these were the only complete and accurate records available, the Division used them as a basis for estimating petitioner's sales. The auditor's supervisor had in his files a chart entitled "How Does Your Business Compare?". The chart lists, by type of business, the cost of various items to the business (e.g., material purchases, salaries and wages, direct labor, rent, taxes). The cost is expressed as a percentage of gross income. A statement at the bottom of the chart declares: "The ratios represent a percentage of gross income (sales). All percentages were derived from representational samples of over 6,000,000 Federal Income Tax returns (Statistics of Income, Internal Revenue Service, U.S. Treasury Department, Statistics Division)." According to the field audit report, the data which formed the basis for the Treasury Department's chart was "in-dated" in November 1984. The same date is handwritten across the top of the chart. In a memorandum of law submitted after hearing, the Division referred to the chart as "Dun and Bradstreet Data".

9. The chart shows that for drinking and eating establishments, the cost of salaries and wages is 14.1 percent of gross income. Based on the 14.1 percent figure, the auditor calculated that petitioner's sales should amount to approximately seven times its payroll costs (100 divided by 14.1). The auditor computed total salaries and wages for the audit period of \$129,556.23, as reported by Paychex. This amount was multiplied by seven to calculate audited sales for the audit period of \$906,893.61 with a tax due on that amount of \$63,482.56. Sales tax paid was subtracted from this amount to determine additional tax due of \$50,647.13.

10. Petitioner established that the wage figures used by the Division included tips as well

as wages paid by petitioner. The figure used by the Division was shown as "Wages, tips and other compensation" on Federal W-3 forms prepared by Paychex for petitioner. The actual amounts paid by petitioner to its employees were the amounts shown as "Social Security Wages" on the W-3 forms. "Social Security Wages" paid by petitioner for the period September 1, 1984 through May 31, 1987 were \$115,675.15.

11. Petitioner introduced a copy of a publication called the Restaurant Industry Operations Report. The report was published in 1987 by the National Restaurant Association, and it was based on replies to a questionnaire received from 920 restaurant operators. It showed that in Italian restaurants with full-menu table service total payroll averaged approximately 34.2 percent of total sales. Petitioner's representative estimated petitioner's sales by dividing petitioner's gross payroll of \$115,675.15 by 34.2 percent. Sales estimated in this way totaled \$338,231.00 for the audit period.

12. Petitioner's representative employed a second methodology to show that the Division overestimated taxable sales for the audit period.

(a) Bank deposits for the months of March, April and May 1987 were totaled. These amounted to \$63,894.57.

(b) Total deposits were reduced in two ways. First, \$215.65, representing a correction made by the bank, was subtracted from the total. An additional \$2,279.88 was also subtracted. The latter amount represented amounts paid to petitioner by its employees to reimburse petitioner for group health and life insurance purchased by petitioner. This resulted in "net business deposits" of \$61,399.04.

(c) Net business deposits were divided by 1.07 to reduce for sales tax included in the deposits, resulting in sales of \$57,382.28.

(d) An error rate of 1.699 was calculated by dividing estimated sales of \$57,382.28 by sales reported on the sales tax return filed for the period ended May 31, 1987 of \$33,770.00.

(e) The error rate was applied to reported sales for the audit period to estimate taxable sales for the audit period of \$311,515.00.

13. To lend further support to his own estimate of taxable sales, petitioner's representative performed two more alternative estimates of tax due. Both employed figures taken from the Restaurant Industry Operations Report and a methodology similar to the one used by the auditor. The first method used the cost of food and beverage as a percentage of total sales. The second method used the cost of food and beverage and gross payroll costs divided by the "prime cost" (this term was not defined in the exhibits offered). Both methods resulted in estimated sales of less than \$300,000.00 for the audit period.

14. Petitioner offered menus showing its prices during the audit period and advertisements from the Syracuse, New York telephone book showing the restaurant's hours of operation. These were offered to show that the restaurant could not have been opened enough hours or sold enough menu items to have had \$906,893.00 in gross sales during the audit period.

15. The relevant portion of the chart used by the Division to estimate petitioner's sales is reprinted below:

Type of <u>Business</u>	<u>Gross Income</u>	<u>Cost of Sales</u>	<u>Gross Profit</u>	
Drinking and Eating	100.00	55.5	44.5	
<u>Total Expenses</u>	<u>Net Profit</u>	<u>Material Purchases</u>		
35.4	9.1	50.5		
<u>Salaries and Wages</u>	<u>Direct Labor</u>	<u>Depreciation</u>	<u>Supplies</u>	
14.1	2.7	2.7	1.3	
<u>Rent</u>	<u>Taxes</u>	<u>Repairs</u>	<u>Interest</u>	<u>Bad Debts</u>
3.6	3.4	1.2	0.7	0.0

Each of the categories as shown above corresponds to a line on a Federal schedule C.

16. On the Federal schedule C attached to its 1984 Federal income tax return, petitioner reported gross income of \$86,538.00 and wages of \$29,190.00. No entry was made on the line provided for cost of labor.

17. The Statistics of Income Division of the Internal Revenue Service ("IRS") publishes a number of reports presenting statistical information based on samplings of Federal tax returns. Among these publications are Individual Income Tax Returns, Publication 1304; Partnership Returns, Publication 369; Statistics of Income Bulletin (published quarterly), Publication 1136; and Corporation Income Tax Returns, Publication 16. None of the tables prepared by the IRS expresses salaries and wages or labor costs as a percentage of gross receipts or sales, as does the chart relied on by the Division.

The tables published in Publication 16 show money amounts in thousands of dollars in various categories corresponding to Federal corporation income tax returns. Cost of sales and operations is shown as one total figure, and it is not subdivided into purchases, cost of labor, materials and supplies, etc., as is the case with the Federal schedule C. Statistics of Income Reported for sole proprietorships and partnerships state cost of labor and salaries and wages as separate categories. Accordingly, it would be possible to prepare a chart like the one relied on by the Division from statistical reports published by the IRS.

18. The Division concedes that it made two errors in calculating taxes due from petitioner. It agrees with petitioner that salaries and wages paid by petitioner during the audit period totalled \$115,675.15. It also states that it was in error in not adding direct labor costs as shown on the chart to salaries and wages in computing a percentage to be applied to petitioner's gross sales. It now asserts that total labor costs are 16.8 percent of sales, according to the chart used, yielding a labor factor of 5.95 (100 divided by 16.8). Applying the labor factor to the corrected calculation of salaries and wages yields total audited taxable sales for the period of \$688,542.00.

CONCLUSIONS OF LAW

A. The Tax Law imposes a tax on the sale of food and drinks by restaurants and taverns (Tax Law § 1105[d][i]). The vendor of food and drinks is required to collect this tax on behalf of the State and is obligated to "keep records of every sale...and of all amounts paid, charged or due thereon" (Tax Law § 1135[a]). Where adequate records are not maintained, the Division is authorized to estimate the tax due on the basis of the information available to it and, if necessary, on the basis of external indices (Tax Law § 1138[a][1];

Matter of Carmine Restaurant v. State Tax Commn., 99 AD2d 581). Considerable latitude is given to an auditor's method of estimating sales where adequate books and records are not available. The audit will stand if there is sufficient evidence to establish that "a rational basis existed for the auditor's computation"

(Matter of Grecian Square v. New York State Tax Commn., 119 AD2d 948). It is then incumbent upon petitioner to show that the method of audit or amount of tax assessed was erroneous (Matter of Carmine Restaurant v. State Tax Commn., supra).

B. Petitioner concedes that it did not maintain adequate books and records, and hence the Division acted within its statutory authority in estimating sales tax due on the basis of external indices; however, petitioner maintains that the Division's calculation of tax due lacked a rational basis. Petitioner's position is based on several grounds.

Petitioner's first argument goes directly to the question of whether the chart in issue provided the Division with a rational basis for estimating tax due. Where tax is estimated on the basis of external indices, sufficient evidence must be placed in the record to allow an independent decision maker to determine whether a rational basis existed for the auditor's calculations (Matter of Grecian Square v. New York State Tax Commn., supra). Essentially, petitioner's argument regarding the manner in which the chart was prepared is an argument that there is not sufficient evidence in the record to support a determination that the use of the chart was rational. Petitioner argues that published IRS statistical reports do not express either salaries and wages or direct labor as a percentage of gross income or sales, as does the chart. Petitioner further notes that IRS statistical reports include direct labor in the category of cost of goods and services and do not separately state either direct labor or salaries and wages as a deductible expense. While petitioner concedes that the information shown on the Division's chart could be obtained from Federal returns, it contends that the IRS does not publish statistics in a format that would enable anyone to prepare the chart relied on by the Division.

While petitioner's arguments are valid as to corporation income tax returns and statistical reports, they are not valid for reports concerning sole proprietorships and partnerships. It is concluded (and has been found as a fact) that a chart like the one relied on by the Division could be prepared from published IRS statistics.

In order to show that a rational basis existed for the use of the chart, it was incumbent upon the Division to lay an evidentiary foundation for the chart. Evidence supplied by the Division in this regard was very weak. The fact that the chart was published by Dun and Bradstreet was stated for the first time in a memorandum of law submitted by the Division. Neither the name of the publication in which the chart appeared nor the date of publication was placed in the record. The audit report states that the information contained in the chart was "in-dated" in November 1984, establishing that the information is relevant to the periods in question here; however, the basis for this statement is not in the record. Nonetheless, the Division claimed no more for the chart than that which was stated on the chart itself ("The ratios represent a percentage of gross income [sales]. All percentages were derived from representational samples of over 6,000,000 Federal Income Tax Returns [Statistics of Income, Internal Revenue Service, U.S. Treasury Department, Statistics Division]"). It is concluded that this explanation was adequate to establish a rational basis for the use of the data found in the chart.

Petitioner next argues that the statistical chart used by the Division was inadequate in that it failed to take into account petitioner's particular location and method of operation. In support of this proposition, petitioner cites an Administrative Law Judge determination. The determination in that case does not control here. Determinations of administrative law judges

have no force or effect in any other proceedings conducted under the authority of the Division of Tax Appeals (Tax Law § 2010[5]). The general principle which controls here is that there must be a rational basis for the selection and application of an external index (cf. Matter of William Savino, Tax Appeals Tribunal, September 22, 1988). The Division selected a payroll factor to estimate petitioner's sales because petitioner's only reliable and complete records were payroll records maintained by an independent firm. The statistical information used by the Division was compiled from 6,000,000 tax returns. While the data is of a general nature, its use in these circumstances was neither arbitrary nor unreasonable. The Division is not required to prove that the statistical data it selected closely reflected the taxpayer's method of operations, merely that there was a rational basis for the Division's computations.

Finally, petitioner maintains that figures taken from the Restaurant Industry Operations Report are more accurate and form a more reliable basis for estimating its tax liability than the chart used by the Division. While there is statutory authority for the estimate of sales tax due by the Division (Tax Law § 1138[a][1]), there is no corresponding authority which would enable petitioner to estimate its own tax liability. At best, petitioner's estimate, using statistics from the Restaurant Report, shows that the Division's audit is imprecise. Such evidence does not establish that the Division's figures are without basis or that the use of those figures was unreasonable (cf., Matter of Meskouris Bros. v. Chu, 139 AD2d 813). Furthermore, petitioner has presented no compelling reason for substituting statistics taken from the Restaurant Report for those taken from the chart used by the Division.

Based on the foregoing discussion, it is concluded that there was a rational basis for the auditor's calculations.

C. Although petitioner has not shown that the audit methodology lacked a rational basis, it did establish and the Division conceded that the Division erred in calculating actual salaries and wages paid by the restaurant during the audit period. The correct wages for the period were \$115,675.17. The Division has further stated its position that it is appropriate to add the "direct labor" category to salaries and wages to compute a total labor percentage. This adjustment is also accepted. Estimated sales calculated on the basis of these adjustments is \$688,542.00. The Division is directed to adjust the tax due accordingly.

D. Petitioner's representative used several different methods of estimating petitioner's tax liability to show that the Division's estimate overstated the amount of tax due. Again, this evidence establishes no more than that the Division's audit was not exact. By its own estimate, petitioner's sales were at least twice that which it reported on its sales tax returns, and it has presented no books or records to verify either its reported sales or its present estimates.

E. Petitioner presented no evidence to show that its failure to comply with the Tax Law was due to reasonable cause and not due to willful neglect; therefore, there is no basis for abatement of penalties (see, Tax Law § 1145[a][1][iii], as renum by L 1985, ch 65, § 86).

F. The petition of the Estate of Alice M. Fashana d/b/a Angelo's Cornucopia is granted to the extent indicated in Conclusion of Law "C"; the Notice of Determination and Demand for Payment of Sales and Use Taxes Due issued on December 18, 1987 shall be modified accordingly; and, in all other respects, the petition is denied.

DATED: Albany, New York
January 12, 1989

/s/ Jean

Corigliano _____
ADMINISTRATIVE LAW JUDGE